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Macroeconomic policy questions: external debt and development: towards a durable solution to the debt problems of developing countries

Follow-up to and implementation of the outcome of the 2002 International Conference on Financing for Development and the 2008 Review Conference

Letter dated 9 November 2009 from the Permanent Representative of Nicaragua to the United Nations addressed to the Secretary-General

I have the honour to refer to the note prepared by the secretariat of the United Nations Conference on Trade and Development (UNCTAD), entitled "Impact of the financial and economic crisis on debt sustainability in developing countries" (see annex), which was presented to the Member States at an informal meeting.

The note was prepared at the request of the outgoing President of the General Assembly, Miguel d'Escoto Brockmann, who asked UNCTAD to prepare a document on the impact of the crisis on debt sustainability. The document is also intended to contribute to the discussions of the ad hoc open-ended working group of the General Assembly, which will follow up on the work of the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development.

I should be grateful if you would have the aforementioned note circulated as a document of the sixty-fourth session of the General Assembly, under agenda items 51 (c) and 52.

(*Signed*) Maria **Rubiales de Chamorro**
Permanent Representative

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Annex to the letter dated 9 November 2009 from the Permanent Representative of Nicaragua to the United Nations addressed to the Secretary-General

[Original: English]

The impact of the financial and economic crisis on debt sustainability in developing countries

Note by the secretariat of the United Nations Conference on Trade and Development
September 2009

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I. Introduction

1. The present paper is prepared in response to a request by the former President of the General Assembly, Miguel d'Escoto Brockmann, dated 6 July 2009 for the United Nations Conference on Trade and Development (UNCTAD) to prepare a paper on the impact of the financial and economic crisis on debt sustainability. Furthermore, the paper is a contribution to the follow-up to the United Nations Conference on the World Financial and Economic Crisis and its Impact on Development, held in June 2009.

2. Section II of the present paper describes the impact of the crisis on developing countries. It shows that this crisis has demonstrated, once again, the vulnerability of developing countries to exogenous shocks and that the global downturn raises concerns with regard to the capacity of developing countries to weather the storm without laying the foundations for a debt crisis in the years to come. In this context, it is essential for policymakers to be aware of key determinants of debt sustainability and how they have evolved over the past two years. Debt sustainability should not be viewed, however, as simply the capacity to continue servicing debt obligations without taking into account the fact that higher debt servicing costs necessarily mean fewer funds available for fighting poverty and meeting the Millennium Development Goals.

3. Sections III shows that developing countries suffer debt crises with debt levels which, by the standards of the advanced economies, are relatively low (a phenomenon often referred to as debt intolerance). In the paper, the conventional wisdom that this phenomenon is a result of poor policies or institutions is rejected and the argument made that the key determinants of debt intolerance are the economic and debt structure of developing countries.

4. Section IV discusses international and domestic long-term policies aimed at reducing the probability of debt crises. This section also highlights that, even with better policies, debt crises and sovereign defaults are bound to happen and that the cost of such crises could be attenuated by putting in place an international debt resolution mechanism, which would allow a speedy, equitable and transparent debt restructuring process.

II. Recent trends

5. The financial crisis ignited by increased defaults on subprime mortgages in the United States of America in 2007 has turned into the most severe global economic downturn in the past 70 years. The crisis spread from the financial sector to the real economy during the course of 2008, and deepened substantially after the bankruptcy of Lehman Brothers in September 2008. During 2008 the debate on the decoupling of developing countries from the evolving economic slump in the developed economies was still inconclusive, but by the end of 2008 the data was clearly signalling that developing countries would face a substantial deterioration in their growth prospects, accompanied by the worsening of a number of key economic and social indicators.

6. Growth in heavily indebted poor countries (HIPC) is expected to average 2.7 per cent in 2009, compared with 5.8 and 5.6 per cent in 2007 and 2008, respectively. For non-HIPC developing countries, gross domestic product (GDP)

growth is expected to slow to 0.7 per cent in 2009, compared with 8.1 per cent in 2007 and 5.7 per cent in 2008. These numbers hide large differences among countries in performance, as the non-HIPC developing countries excluding China are expected to record a decrease of 1.8 per cent of their GDP in 2009 compared with 2008, and about 62 (out of a total of 166 countries for which data are available) developing countries are expected to record negative output growth in 2009, while an even larger number of countries are expected to record negative growth in per capita terms.

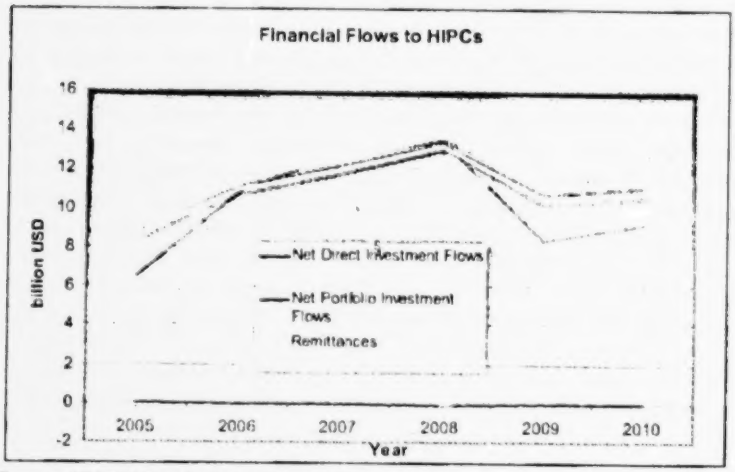
7. Developing countries as a group registered a current account surplus of 3.5 per cent of their gross national income (GNI) in 2007, but by 2008 the surplus had dropped to 2.5 per cent of GNI and is expected to shrink to 1.6 per cent in 2009. A few countries with large surpluses heavily influence the group average; excluding China, the figures look even more worrying. Non-HIPC developing countries registered a current account surplus of only 0.8 per cent of GNI in 2007 in 2008 had already moved to a deficit of 0.3 per cent of GNI. Moreover, over half of the developing countries had current account deficits exceeding 6 per cent of GNI in 2008, and HIPCs as a group recorded a current account deficit of 6.8 per cent of their GNI in 2008.

8. The deterioration in developing country current accounts was largely driven by the collapse in exports and to a lesser degree by a decrease in remittances. The drop in exports owing to decreased global demand led to a decline of 30 per cent in the value of globally traded goods between September 2008 and March 2009. This decrease is explained by a simultaneous slump in export volumes and export prices, especially in the commodity sector. Although low-income countries dependent on single-commodity exports are likely to suffer most in the course of the crisis, owing to a sharp contraction industrial activity in developed countries between late 2008 and mid-2009, middle-income developing countries have also recorded large decreases in exports, reflecting a sharp deterioration of trade in manufactured goods resulting from a reduction in spending by consumers in the developed and developing countries.

9. As remittances account for a relatively small fraction of the income of migrants, these flows tend to be fairly stable even during economic downturns. This explains why remittances have proven to be more resilient than other financial flows in the recent crisis, though some countries suffered sharp declines. After peaking at a record $328 billion in 2008, remittances to developing countries are expected to decrease by 7.3 per cent in 2009, compared with a drop of over 50 per cent in net private financial flows during the same period. The drop in remittances is directly linked to the recession in advanced market economies and the decrease in the aggregate earnings of migrant workers who are often employed in the hardest-hit sectors, such as construction and automobile production. The region most affected by the decline in remittances will be sub-Saharan Africa, registering an 8.3 per cent decrease, followed by Latin America with a decline of 6.9 per cent. Remittances from workers are regarded both as an important stabilizing factor in current account dynamics for many developing countries and as a cushion against poverty for receiving households. It is this latter effect that has caused concern for many developing countries, as the weakness of the economy and decreasing Government revenues are already jeopardizing a number of social programmes.

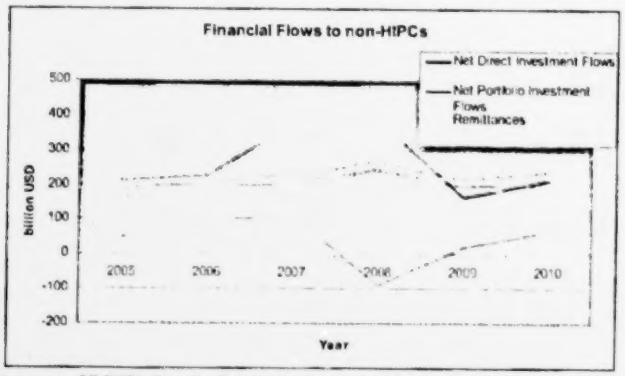
10. Owing to a general decrease in other financial flows, the relative importance of remittances has grown, notably for smaller developing countries. In HIPCs, remittances will overtake net direct investment flows in 2009, the latter decreasing as a consequence of the financial crisis by more than 30 per cent in 2008-2009 (see figures I and II). It is expected that the countries most affected by the drop in remittances in 2008 and 2009 will be Guyana, Haiti, Honduras, Lesotho, the Republic of Moldova and Tajikistan.

Figure I
Financial flows to heavily indebted poor countries



Source: UNCTAD calculations based on International Monetary Fund (IMF) *International Financial Statistics*, UNCTAD *World Investment Report*, national sources and Economist Intelligence Unit (EIU) estimates.
Note: Based on data availability.

Figure II
Financial flows to non-heavily indebted poor countries

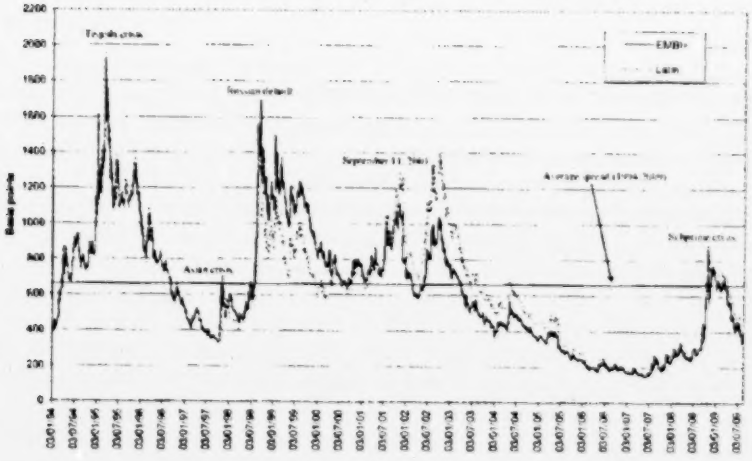


Source: UNCTAD calculations based on IMF *International Financial Statistics*, UNCTAD *World Investment Report*, national sources, and EIU estimates.
Note: Based on data availability.

11. While it is true that some developing countries may benefit from moving from a current account deficit to a current account surplus position and that developing countries with a current account surplus may receive limited or no benefits from financial globalization and the associated private capital inflows,[1] it is also true that adjustments should be gradual. Therefore, a sudden halt of private capital flows may be a source of considerable pain, at least in the short run. Coping with such a reversal of private inflows is one of the main policy challenges for a number of developing countries in 2009. This is especially, but not uniquely, true for those countries which are running a current account deficit. Net private capital flows, which surpassed $900 billion at the peak of the previous cycle in 2007, dropped to $465 billion in 2008 and are expected to be below $200 billion in 2009. Not only has the availability of external private finance decreased over the past two years, but the cost of accessing international capital has also become higher to developing countries as the financial turmoil has deepened. The global financial crisis and the accompanying rise in risk aversion, in particular after the collapse of Lehman Brothers in September 2008, led to a drastic increase in sovereign borrowing spreads for emerging markets as a group. The spread over comparable treasuries increased from around 200 basis points in mid-2007 to over 850 basis points at the height of the crisis in late 2008 and early 2009 (see figure III). Following a series of interventions by monetary and fiscal authorities around the world and the propagation of the view that the global financial system would not collapse, spreads started decreasing from late February 2009 and have now dropped to levels that had prevailed prior to Lehman's bankruptcy. Current spreads of 350 basis points, however, still imply higher borrowing costs for emerging markets as a group compared with pre-crisis levels and, for countries that rolled over their debt during 2009, a heavier debt service burden on their economies in coming years.

Figure III

Emerging Markets Bond Index composite and Latin spreads

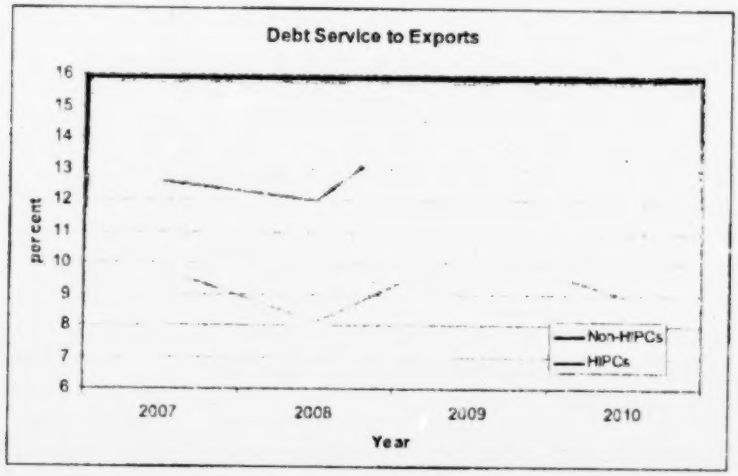


Source: Bloomberg.

[1] UNCTAD, *Trade and Development Report, 2008* (United Nations publication, Sales No. E.08.II.D.21).

12. With a synchronized global financial crisis and the resulting sudden halt of credit provision, the International Monetary Fund (IMF) has been functioning as the lender of last resort. Therefore, the severity of balance-of-payment difficulties encountered by developing countries is exemplified by the fact that the average number of countries seeking non-PRGF[2] IMF loans amounted to six per year prior to the crisis, whereas from October 2008 to August 2009 alone the number of countries accessing such facilities increased to 24. Furthermore, whereas the average amount of disbursed IMF funds for all non-PRGF programmes averaged 2 billion special drawing rights (SDRs) a year between 2003 and 2007, the support for the 24 countries from the end of last year amounted to over SDR 100 billion. Debt stock reductions associated with the HIPC Initiative and the Multilateral Debt Relief Initiative, coupled with the robust international growth of the previous years, led to an impressive improvement in debt indicators between 2003 and 2007. While total public debt held by developing countries increased by $176 billion during 2008, basic debt ratios still showed a moderate decline, as the full impact of lower export and slower GNI growth had not yet filtered through to developing countries. The decline in global demand and the resulting drop in the growth and export performance of developing countries will partially reverse the big gains made on the external debt front through the end of 2008, however. For example, the debt service to exports ratio is expected to worsen for both HIPCs and non-HIPCs during 2009 (see figure IV).

Figure IV
Debt service to exports ratio



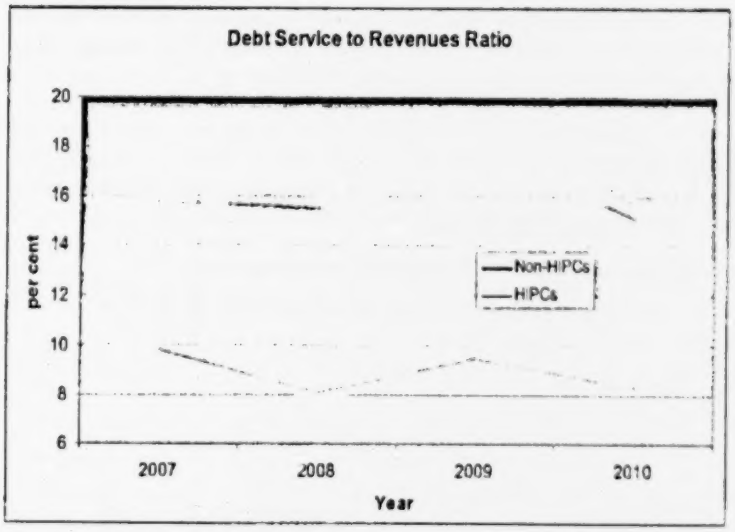
Source: UNCTAD calculations based on World Bank *Global Development Finance*, and EIU estimates.

13. It is likely that debt service burdens, both as a share of exports and as a percentage of Government revenues will remain more elevated both during 2009

[2] IMF Poverty Reduction and Growth Facility. The present report looks at non-PRGF programmes as they reflect the changes in the economic landscape excluding the ongoing HIPC activities, which follow a timetable of their own.

and well into 2010 than in the pre-crisis years. In 2009, debt service in relation to Government revenue will increase by more than 17 per cent for both HIPCs and non-HIPCs (see figure V). For HIPCs, this increase is the result of both an increase in absolute debt service payments and a substantive decrease in Government revenues. Even prior to the crisis, the capacity of many developing countries to meet the Millennium Development Goals was constrained by a lack of domestic resources, and the increased share of Government revenues devoted to debt servicing is worrisome, as more countries are likely to fall behind on planned poverty reduction programmes. According to the 2009 Millennium Development Goals report,[3] the number of people living in extreme poverty is expected to be an estimated 55 to 90 million higher compared with the pre-crisis level. In this context, the UNCTAD secretariat has proposed a temporary debt moratorium on official debt for low-income countries, which would amount to approximately $26 billion for 49 low-income countries for 2009 and 2010.

Figure V
Debt service to revenues ratio



Source: UNCTAD calculations based on IMF *Government Finance Statistics*, national sources, and EIU estimates.

14. A recent study commissioned by UNCTAD found that the global financial crisis has substantially weakened the banking sector in a number of low-income developing countries.[4] Looking at financial leverage, measured as total liabilities divided by total equity from bank balance sheet information, the study finds an increase in this indicator during the post-crisis period. Furthermore, the total bank capital ratios of most countries have shown a decrease in the post-crisis period as

[3] *The Millennium Development Goals Report 2009* (United Nations publication, Sales No. E.09.I.12).

[4] Amar Gande and Lemma W. Senbet, "The impact of global economic crisis on debt sustainability of low-income countries", UNCTAD informal paper, 2009.

compared with the pre-crisis period. Interestingly, the ratios tend to be worse for domestic banks owned by foreign banks, reinforcing the increasingly held view that developing counties have suffered disproportionately for the excesses generated by international centres of private finance. If the global crisis extends beyond 2010, the risk of bank failures would increase in some developing countries, adding further pressure on their already strained budgetary positions, as Governments would be obliged to rescue some of the big banks, the failure of which would pose a systemic risk to the economy. Even in the more optimistic scenario under which global growth resumes in early 2010, a weakened domestic banking sector could hamper a rapid resumption of economic activity in developing countries and thus further delay the achievement of the Millennium Development Goals. The weakening of the banking sector in developing countries, caused by the financial crisis shows once again how developing countries, as innocent bystanders of the crisis, nevertheless have to cope with the repercussions of the crisis, which has derailed or slowed down their economic growth. It also demonstrates the different trajectories of the financial crisis in different countries. In the developed world, the economic crisis was triggered by the financial sector, while in many developing countries it was the global economic crisis which brought problems to their financial sector. Though there was a time lag, the negative impact on growth, poverty reduction and debt-servicing capacities could nevertheless be significant.

III. Debt sustainability in developing and advanced economies

15. Developing countries and transition economies are subject to frequent debt crises which are characterized by low credit ratings and high sovereign spreads.

16. Of course, different developing countries face different types of problems. Low-income countries are indeed unable to sustain high levels of debt. This is unlikely to be a result of poor institutions and policies, as it is often claimed. Low tolerance to debt is driven by the fact that these countries have poorly diversified economies and are excessively reliant on the exports of a few commodities. This leads to a vicious circle. Low-income countries need credit to develop their productive sector and diversify their economies, but, if they borrow, they end up suffering the devastating and destabilizing consequences of debt crises. The answer to this dilemma is more concessional finance.

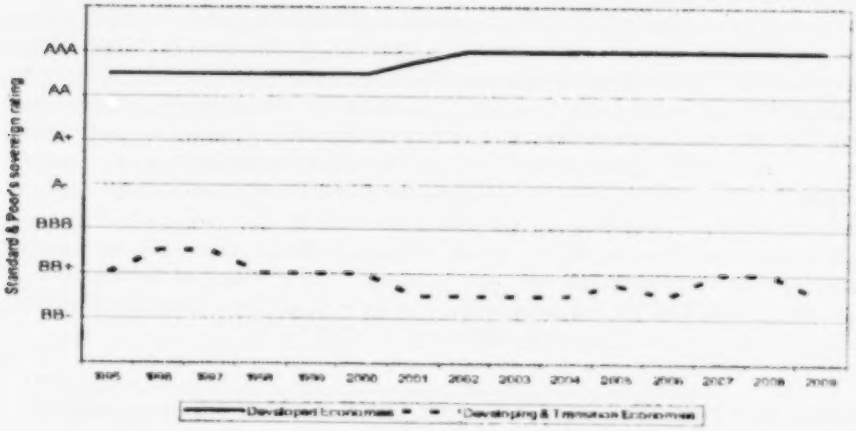
17. Middle-income countries that can access the international capital market face different types of problems. On average, it is not true that these countries go into crisis because they borrow "too much" (even though this is the case for some of them). Frequent crises are instead driven by a suboptimal debt structure which is partly the consequence of a poorly designed international financial architecture.

18. This latter point can be illustrated by looking at credit ratings, sovereign spreads[5] and debt levels. Over the period 1995-2009, the median sovereign credit rating of a large sample of developing countries oscillated between BB- and BBB while the median credit rating of the advanced economies remained above AA+ (see figure VI). Low credit ratings lead to high and volatile borrowing costs. During

[5] Sovereign spreads measure the difference between the borrowing cost of the Government of the United States and that of dollar-denominated debt issued by emerging countries. The difference in borrowing costs derives from the pricing of perceived risks of default and expected losses.

1994-2009, spreads on dollar-denominated sovereign debt averaged 640 basis points and went as high as 1,920 basis points (see figure III). This poses the following questions: What are the roots of this situation? Why do developing countries have low ratings and high and volatile spreads?

Figure VI
Median Standard & Poor's credit rating in developed and developing economies



Source: UNCTAD calculations based on Bloomberg data.

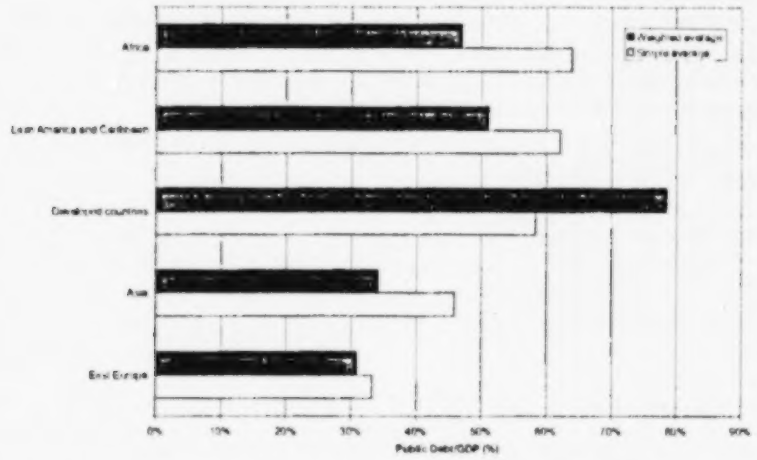
19. An economist's natural answer to the above questions is "bad fundamentals"; however, the excessive volatility of emerging market spreads casts doubt on any explanation that is purely based on "fundamentals". Volatility would be justified if it were caused by the choice of domestic policies, with low spreads rewarding good policies and high spreads punishing bad policies; however, there is overwhelming evidence that volatility is often driven by external factors.[6] It is hard to identify changes in fundamentals that would justify the abrupt swings in spreads documented in figure III.

20. The same argument can be made by looking at the level of public debt over GNI, which is one of the most commonly used indicators of a country's ability to face its obligations. Figure VII shows that, on average, developing countries do not have levels of public debt that are substantially higher than those of the advanced economies. When examining simple averages, only Africa and Latin America have debt levels which are higher than the developed countries, but the difference is fairly small (6 percentage points in the case of Africa and 4 percentage points in the

[6] For instance, sovereign spreads in Latin America reached a high of 1,700 basis points after the Russian crisis in 1998, yet Latin America had no economic connections with the Russian Federation. This was a case of "financial contagion" driven by the fact that the same Wall Street investors who held Russian bonds also held Latin American bonds. When the Russian Federation defaulted in 1998, these investors indiscriminately sold the whole asset class. Even starker examples of the exogenous nature of volatility are the sudden increase in spreads in the aftermath of the 11 September 2001 attacks and the current financial crisis. Both of these events concerned the centre of the world financial system but had a large negative effect on the borrowing costs of emerging market countries.

case of Latin America). In contrast, Asia and Eastern Europe have average debt levels which are substantially lower than the average of the developed economies.[7]

Figure VII
Public debt as a percentage of GDP (2004-2008)



Source: "Public debt around the world: a new dataset of central Government debt", Ugo Panizza and Dany Jaimovich, *Applied Economics Letters* (March 2008).

21. These relatively low levels of debt do not mean that debt is not a problem for developing countries. On the contrary, they mean that debt is a much bigger problem for developing countries than for the developed countries. Japan has a public debt ratio to GDP that is well above 150 per cent, yet there is little concern about the solvency of Japan. At the same time, developing countries often face debt crises with debt levels which are as low as 30 per cent of GDP. There is something that makes debt riskier in developing countries. What is it? Why is debt a big problem for developing countries and a much smaller problem for the developed countries?

[7] In fact, weighted averages, which place greater weight on larger economies, show that developed countries have the highest debt levels. It may be argued that the above discussion, which focuses on total public debt, is misleading because developed countries have much lower levels of external debt with respect to developing countries. There are two possible answers to this criticism. The first is that debt sustainability exercises that focus only on external debt are flawed. There is ample evidence that domestic public debt is a considerable source of vulnerability and that many debt crises originate in the domestic debt market (Carmen Reinhart and Kenneth Rogoff, "The forgotten history of domestic debt", National Bureau of Economic Research working paper 13946, 2008). Moreover, in a world in which several emerging market countries have open capital accounts and borrow by issuing bonds, the distinction between external and domestic debt becomes somewhat artificial. Second, a comparison of the external debt situation of the developing world with that of the United States shows that there is no evidence that the United States has lower external debt than the average developing country. While there is some worry about a possible depreciation of the United States dollar, there is little concern about a default by the United States Government; yet United States Treasury bonds continue to carry a AAA credit rating and pay very low interest rates.

The standard explanation

22. According to conventional wisdom, this situation is a result of the presence of poor policies and institutions. With respect to policy prescriptions, this view maintains that the only way in which developing countries will be able to sustain higher levels of debt is by improving their institutional set-ups. However, the argument goes, improving institutions will require time and effort; in the meantime, developing countries should maintain low levels of debt. This is the approach at the base of the IMF/World Bank Debt Sustainability Framework for low-income countries, which relates the level of sustainable debt to the score of the World Bank's country policy and institutional assessment index.

23. This view, which may be labelled as "institutional fundamentalism", appears to be too strong in its conclusions and is not consistent with the high levels of volatility documented above. Such volatility in borrowing costs is often driven by the fact that foreign investors can change their minds very rapidly. The same policies and institutions that in one moment are deemed to be prudent and are "rewarded" with massive capital inflows and low spreads can suddenly become, in the view of investors, irresponsible and be "punished" with large capital outflows and high spreads.[8]

The role of debt structure

24. An alternative and more promising explanation focuses on debt structure. It argues that what matter are the characteristics of the debt contract. For instance, the literature on "original sin"[9] has focused on the currency composition of external debt and argued that the presence of foreign currency debt plays a key role in reducing debt sustainability.[10] Debt maturity is also important because short-term debt leads to rollover risk and thus increases vulnerability vis-à-vis long-term debt. The Mexican crisis of 1994/95 and the Russian crisis of 1998 are clear demonstrations of the vulnerabilities linked to maturity mismatches (see appendix).

25. Focusing on currency composition helps to explain why developing countries face frequent debt crises and a country like the United States faces no problems sustaining its debt. The difference is not a result of where they borrow, as they both borrow abroad and, on average, developing countries borrow abroad less than the

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[8] United Nations Conference on Trade and Development, *Trade and Development Report, 2009* (United Nations publication, Sales No. E.09.II.D.16).

[9] See Barry Eichengreen and Ricardo Hausmann, "Exchange rates and financial fragility", National Bureau of Economic Research working paper 7418 (1999); Eichengreen, Hausmann and Ugo Panizza, "The pain of original sin", in *Other People's Money: Debt Denomination and Financial Instability in Emerging Market Economics*, Eichengreen and Hausmann (eds.), (Chicago, Illinois, University of Chicago Press, 2005).

[10] Consider the case of two countries with similar debt levels but with different debt composition: country D has all of its debt denominated in domestic currency and country F has all of its debt denominated in foreign currency. Further assume that the two countries enter a recession and decide to adopt expansionary macroeconomic policies, which lead to a depreciation of their currencies. In country D, the expansionary policies are likely to stimulate the economy and improve both external and debt sustainability. In country F, the currency depreciation will increase the domestic currency value of the debt (this is often referred to as a negative balance-sheet effect) and may lead to a higher debt ratio and possibly to a debt crisis. As a consequence, countries with a large amount of foreign currency debt may face serious constraints in conducting countercyclical macroeconomic policies.

United States does. They even borrow abroad in the same currency as the United States (mostly the United States dollar); the difference is that the United States can print the dollar, whereas developing countries cannot.

IV. How to make debt safer

26. There is a heated debate on why countries have different debt structures and whether it is possible to introduce new instruments that can improve debt sustainability.

27. In one camp there are those who, while not denying the role of good institutions and policies, argue that the set of debt instruments currently available to developing countries is mainly the result of a combination of historical accidents and inertia. As a consequence, it is possible, although not easy, to introduce new and better debt instruments that can improve debt sustainability. In the opposite camp, there are those who argue that the available set of instruments is just a reflection of institutional failures which lead to poor contract enforcement and a lack of policy credibility. According to this view, there is no shortcut and nothing can be done without addressing institutional failures.

28. The latter view appears to be too extreme. While it is unlikely that new financial instruments will, by themselves, allow developing countries to sustain the same debt levels that can be sustained by many developed countries, marginal improvement in debt structure is likely to reduce the probability of a debt crisis, at any given level of debt.[11] Moreover, most developing countries have investment opportunities with a potential return that is higher than the cost of funds. Hence, in theory, borrowing to finance these projects can improve a country's welfare. In some cases, developing countries may be able to finance these investment projects by mobilizing domestic resources. In other cases, external debt is the only alternative.

Avoiding over-borrowing

29. Innovative debt instruments can limit the risk of a debt crisis at any level of debt; however, for any set of debt instruments, the risk of a debt crisis can be reduced by borrowing less. This suggests that the first step towards achieving debt sustainability is to borrow for the right reason and not borrow too much during "good times". This does not mean that countries should not borrow, but rather that they should not over-borrow. Borrowing for the right reason means that debt should only be used to finance projects that generate returns which are higher than the interest rate charged on the loan. Moreover, foreign currency borrowing should be

[11] A standard answer to this claim is that if such new instruments were viable there would be no need for policy interventions because the market would provide them. This line of reasoning does not recognize that the creation of innovative instruments would lead to positive externalities and therefore limit market incentives for the supply of such instruments (Eduardo Borensztein, Eduardo Levy Yeyati and Ugo Panizza *Living with Debt: How to Limit the Risks of Sovereign Finance*, (Boston, Harvard University Press; Washington, D.C., Inter-American Development Bank, 2006).

limited to projects that can either directly or indirectly generate the foreign currency necessary to service the debt.[1,12]

30. A way to maintain prudent debt levels is to complement macro-level debt sustainability analysis with a careful evaluation of the sustainability of each project. Before borrowing abroad, a country should evaluate a project by asking the following three questions: (a) Will the project have a social return that is higher than the cost of funds? (b) Will the project generate the amount of foreign currency necessary to service the debt? (c) Will the resource flows match the payment schedule of the debt contract? Only projects with positive answers to the above three questions should be financed with standard external debt contracts. It is likely that in low-income countries there are several high social return projects that do not satisfy the second and third requirements, in which case such projects should be financed with grants and concessional loans.

31. Excessive borrowing by the public sector is often driven by political or electoral considerations and by the fact that politicians may decide to maximize their own welfare rather than that of their constituencies. There is, by now, ample empirical evidence that public sector over-borrowing can be limited by increasing the transparency of the budgetary process and the reliability of fiscal and debt statistics (see below) and by having a well-working system of automatic fiscal stabilizers. Of course, discretionary fiscal policy remains important, especially at times of crisis, but it should be accompanied by rules that reduce the potential to generate a deficit bias (chapter 7 of the 2008 *Trade and Development Report* provides a detailed discussion of these issues).[13]

32. This highlights the important role of responsible borrowing and lending. Although there is no agreed set of definitions or principles, shared responsibility by both borrowers and lenders is crucial to avoiding the unsustainable (and sometimes fraudulent) accumulation of debt. UNCTAD has launched a project that aims to address some of these issues, which includes the development of guidelines and criteria for assessing the legitimacy of sovereign debt.

33. Excessive borrowing, especially external borrowing, is also an issue for the private sector.[14] In fact, in many cases it is impossible to separate public from private liabilities. This is especially the case for bank debt. The presence of implicit or explicit deposit insurance implies that, in the case of a banking crisis, bank liabilities are absorbed by the public sector. Thus, the external debt of private banks is a contingent external liability of the public sector.

34. Moreover, there are conditions under which private external debt may lead to over-borrowing and end up generating more vulnerabilities than public sector

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[12] Since money is fungible, the latter statement does not need to be applied literally. Whenever a country borrows abroad, however, it needs to make sure that the economy can generate the external resources necessary to service the debt.

[13] The need to increase spending and cut taxes during bad times is often not matched by the desire or ability to cut spending or increase taxes in good times.

[14] According to the Lawson-Robichek doctrine, any payment problem linked to private external debt would only affect the parties directly involved in the debt contract and would not have the macroeconomic effects that are typically associated with sovereign debt crises. This view was discredited by the debt crisis of 1982 and the Asian crisis of 1997/98, which hit several countries with large current account deficits but high private investment rates and balanced fiscal accounts.

external debt. For instance, in most developing countries, the cost of borrowing is linked to total (public and private) foreign debt; thus, external borrowing generates a negative externality, because each borrower increases the cost of funds for all other borrowers. If the Government is the only borrower, it will make its borrowing decision by taking into account the effect of this upward sloping supply of funds; however, private agents do not internalize the fact that their borrowing decisions have a negative effect on the borrowing costs for other agents and will thus borrow more than what is socially optimal.

35. Another source of vulnerability is linked to the presence of moral hazard. Private borrowers may decide to minimize borrowing costs and accumulate currency and maturity mismatches if they think that they will be bailed out in the event of a currency or liquidity crisis. In particular, currency mismatches linked to the presence of liabilities in foreign currency and assets in domestic currency have been at the root of many debt crises, including the Asian crisis of 1997/98 and the current problems facing several countries in Eastern Europe and Central Asia. This problem cannot be solved by simply requiring banks to match their foreign currency liabilities with foreign currency assets. Even if a bank perfectly matches its assets and liabilities, a currency devaluation can hurt the bank's balance sheet if the bank's clients have a currency mismatch (this is the case when firms that produce non-tradable goods borrow in foreign currency or when households hold foreign-currency-denominated mortgages). In fact, some private agents amplify potential mismatches linked to their normal borrowing needs by engaging in carry trade and speculating with derivative products. These activities may end up causing them enormous losses; the unwinding of these speculative positions contributed to destabilizing several foreign exchange markets.[15]

36. Prudential regulation should be aimed at avoiding such mismatches, but the implementation of such prudential regulation is made difficult by the fact that external private borrowing is more opaque than external public sector debt and that the total external exposure of the private sector is more difficult to measure and quantify than the external exposure of the public sector. This opaqueness is complicated by the fact that private sector entities often take currency risks by using sophisticated derivative instruments. Given these problems, there are instances in which controls on capital inflows can play a useful role in limiting over-borrowing and losses in external competitiveness.

Improving debt management

37. The current crisis has once again highlighted the importance of effective debt management for debt sustainability in developing countries. As with previous crises, effective management of a country's public debt has proved to be a valuable asset in mitigating the effects of external shocks. Effective debt management contributes to the attainment and maintenance of sustainable debt levels through three key dimensions: providing input to the decision-making process, implementing policies and ensuring adequate coverage of the country's debt.

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[15] For a discussion of carry trade, see UNCTAD *Trade and Development Report, 2007*, Chapter I. For a discussion of derivative-related exposures in the corporate sector, see Alejandro Jara, Ramon Moreno and Camilo Tovar, "The global crisis and Latin America: financial impact and policy responses", *BIS Quarterly Review*, June 2009.

38. The input of debt management to the Government's decision-making process consists of the provision of debt data and strategy proposals. The availability of reliable and timely debt data is essential for prudent risk analysis and the elaboration of Government strategies aimed at ensuring sustainable debt levels. Key factors are the allocation of an adequate number of trained staff, efficient information flows and the implementation of effective management information systems. Additionally, the Government must be prepared to make use of the information and recommendations that the debt management function can provide. In countries where these conditions are met, debt sustainability analysis can rely on accurate data, and the resulting policies are strengthened; where this is not the case, the analysis and resulting decision-making suffer.

39. For the implementation of policies, appropriate regulatory frameworks, organizational structures and operational procedures are essential. When the appropriate legal and institutional frameworks are in place and the organizational structure defines clear responsibilities, the consequential improvements in accountability and transparency levels promote the effective implementation of Government policies for achieving debt sustainability. On a macroeconomic level, debt management must be treated as an integral part of the Government's overall macroeconomic framework, strengthening the decision-making process and ensuring consistency with other macroeconomic objectives and policies. At the microadministrative level, debt management functions must be integrated with the broader processes of public finance management and administration, including integrated financial management systems. Countries that satisfy these conditions have been able to use debt management to mitigate the effects of financial crises. Where these frameworks, structures and resources are lacking or are weak, however, there is insufficient capacity to effectively implement Government policies related to debt sustainability, resulting in inconsistency between Government objectives and actual results.

40. Another prerequisite for debt management to support debt sustainability is full coverage of a country's public and publicly guaranteed debt obligations, as well as the monitoring of private non-guaranteed and short-term debt. The Asian crisis underlined the need for Governments to maintain comprehensive coverage of such liabilities; however, many countries still have limited coverage of their debt, maintaining debt records for only some categories of central Government debt. The consequence of this incomplete information is weaker ability to undertake comprehensive risk and debt sustainability analysis.

Developing new debt instruments

41. Developing countries can reduce the risks of a debt crisis by consistently running fiscal and current account surpluses; however, even if a country decided to do so (and there are several reasons why this may not be optimal or feasible), it would still be left with an existing stock of debt. As financial crises are often driven by liquidity problems and not by solvency problems (and even solvency problems are sometimes the outcome of a liquidity crisis), having a debt structure that limits the risks of such a crisis is key for guaranteeing sustainability.

42. Section 3 above highlighted the risks of foreign currency borrowing. Several developing and emerging market countries have been successful in reducing these risks by switching from the international to the domestic debt market. This option is

not available to all countries, however, and several developing countries still need to rely on the international capital market, where issuing in domestic currency is extremely difficult. The international financial institutions can help broaden the investor base for long-dated local currency instruments by issuing their own bonds in the currencies of their borrowing countries. In the past, multilateral development banks issued bonds denominated in the currencies of emerging economies, with the objective of minimizing their own borrowing costs. Recently, they accelerated this process because they recognized that by borrowing in local currencies they could provide support for the creation of markets for such instruments and thus contribute to development by using both the asset (their loans) and the liability (their funding) sides of their balance sheets.[16] Of course, these policies would become easier if the international financial architecture would move towards a less dollar-centric system (see the 2009 *Trade and Development Report* for proposals in this direction).

43. Debt sustainability could also be improved by issuing contingent debt instruments. For example, GDP-indexed bonds are of particular interest because they provide for lower payments when capacity to pay is low.[17] Creating a market for such securities poses a number of challenges, however, especially because someone needs to pay the fixed cost linked to the design and issuance of the new instrument. Also in this case, the international community could play an important role by providing technical assistance and strengthening the quality and reliability of the statistics necessary for pricing the new instruments. In the extreme, the international financial institutions could be the first to issue innovative and contingent debt instruments.

44. The creation of new instruments may require intervention at the international level because of the required market size, externalities and the need for homogenous standards, but the international community could also help address a more fundamental problem. Issuing local currency or contingent debt is analogous to paying an insurance premium. In order to accept debt instruments with a more variable return, international investors are likely to ask for some form of compensation. Paying such a premium might be politically costly, and policymakers may object to an insurance policy that may benefit future Governments.[18] If the international financial institutions were to create a critical mass of these instruments

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[16] Eichengreen and Hausmann, in "Original sin: the road to redemption", in *Other People's Money* (see footnote 9), proposed that the multilateral development banks should issue bonds denominated in an index that pools currency risk from a diversified group of emerging economies.

[17] For discussions of GDP-indexed bonds, see Eduardo Borensztein and Paolo Mauro, "The case for GDP-indexed bonds", *Economic Policy*, vol. 19, No. 38, pp. 165-216, April 2004; see also Stephany Griffith-Jones and Krishnan Sharma "GDP-indexed bonds: making it happen" Department of Economic and Social Affairs working paper No. 21, ST/ESA/2006/DWP/21, April 2006.

[18] Recently, the Minister of Finance of Mexico received high praises for having adopted a prudent policy aimed at hedging against the volatility of oil prices. This hedging policy was prudent and wise, and it would have been prudent and wise even if the prices of oil had increased instead of decreased (like buying insurance is prudent even if one does not have accidents); however, one could imagine the type of criticism the Mexican Government would have been subject to if the price of oil had increased instead of decreased. This type of political risk is one of the main reasons why policymakers have limited incentives to enter into such insurance contracts. In fact, even articles that praised the Mexican Minister, Agustin Carstens, labelled this policy as a "gamble" rather than as a prudent insurance policy (Javier Blas, "Mexico's big gamble on oil pays off", *Financial Times*, 8 September 2009).

and demonstrate their benefits, it would be harder for self-interested politicians to reject the use of such instruments.

V. Conclusions

45. The financial and economic crisis of the past two years has highlighted the need for further policy actions both at the domestic and international levels in order to generate economic growth rates in developing countries capable of preserving debt sustainability as well as meeting the Millennium Development Goals. In this regard, it is important to distinguish between short-term actions aimed at minimizing the impact of the current crisis and longer-term policies that would need to be implemented to increase the robustness of the global economy and reduce global imbalances.

46. In times of crisis, low-income countries have smaller margins to manoeuvre when it comes to weathering external shocks. Accordingly, an immediate short-term measure to be adopted when a crisis erupts is for lenders to provide low-income countries with greater flexibility to respond to external shocks. Within the context of the current economic crisis, in April 2009 UNCTAD called for a debt moratorium on the sovereign debt of low-income countries to provide them with the breathing space they needed to mitigate the negative impact of the global crisis. Encouragingly, in July 2009 IMF announced the provision of interest payments relief to low-income countries in the form of zero payments for concessional lending facilities until the end of 2011.

47. At the Group of Eight (G-8) summit in Gleneagles and at the Millennium Summit of the United Nations, countries decided to increase official development assistance (ODA) flows to $130 billion by 2010. Although there are encouraging signs that a number of countries are on track to meet their national targets, some countries have cut aid budgets at a time when ODA is more important than ever in mitigating the negative impact of the global economic and financial crisis. It is important that all donor countries fulfil the existing pledges, and go beyond them, in the light of the difficult situation faced by developing countries. Additional aid would be essential for meeting the Millennium Development Goals, as the current targets were agreed before the financial crisis slashed economic growth and Government revenues in developing countries and created a situation where a number of countries have to curtail their social spending in order to maintain macroeconomic stability and ensure debt sustainability.

48. Some heavily indebted poor countries are moving again towards an unsustainable debt position. The number of high-risk post-completion point countries increased from four to five over the last 12 months.[19] This increase is particularly worrisome, as there is no scope for further debt relief for this country group. Continued and increased access to highly concessional finance is therefore needed to maintain debt sustainability beyond the completion point.

49. In terms of longer-term actions, policies aimed at improving debt sustainability in low-income countries should start by recognizing that such countries have enormous needs in terms of investment in social and physical infrastructure but a

[19] "Heavily Indebted Poor Countries Initiative and Multilateral Debt Relief initiative: status of implementation", report prepared by the International Development Association and IMF, September 2009.

limited ability to sustain the external debt necessary to finance these investments. Such countries therefore face a dilemma. Either they must maintain sustainability and forego investment opportunities with high social returns, or they must try to borrow and invest as much as they can but then face recurrent debt crises. Both options will lead to low growth: the first, which is implicit in the World Bank/IMF debt sustainability framework, because of low investment and the second because of high volatility and stop-and-go cycles. A way out of this Hobson's choice would be full debt cancellation and a large step up in aid. Such a "big push" would produce a virtuous circle that might put today's low-income country on a path of stable growth and sustainable debt. Even though developed countries made several pledges to scale up aid to low-income countries (especially in Africa), there is no evidence of a major rethinking of international policy towards the debt problems of low-income countries.

50. Several middle-income countries entered the crisis with relatively strong fundamentals (as measured by current account surpluses and large international reserves). This position of relative strength, contributed to averting a more profound economic downturn than the one that some other middle-income countries are going through. As opposed to previous global shocks, several emerging market economies managed to avoid a collapse of their domestic currencies, and their banking sectors remained stable. As the world emerges from the near collapse of the global financial system, however, it is time to think about medium-term policies that would improve the financial prospects of emerging market countries.

51. It is worth mentioning that this crisis makes countries reconsider some of their policies and becomes an opportunity to introduce changes. It has, once again, shown the dangers of excessive foreign borrowing, both on a net and a gross basis (i.e., foreign borrowing that is not driven by a current account deficit). Hopefully, more developing countries will learn from this crisis and start to adopt prudent policies, which will isolate them from the vagaries of international finance. This transition, however, needs to be gradual. A sudden swing from a current account deficit to a current account surplus, which originates from a capital flow reversal, may have serious economic costs.

52. Economists and practitioners are now converging towards the idea that debt crises are related to both debt levels and debt composition and that there are important interactions between domestic public debt and external debt. Improving debt management capacity at the domestic level can lead to a more optimal debt composition and can reduce the risks of over-borrowing. At the same time, international policies can help developing countries to move to a safer debt structure, which would make the countries more resilient to external shocks. One of the reasons for developing countries' high cost of borrowing is that a lack of accurate and timely information on debt level and debt structure is associated with a perceived increase in the risk of the debt issued by these countries; the international community should devote more funds for technical assistance to reinforce the ability of developing countries to effectively manage debt and report accurate statistics.

53. Even in the presence of a more coherent international financial system, sovereign defaults are bound to happen. It is thus necessary to put in place a debt resolution mechanism aimed at guaranteeing a speedy and fair resolution of sovereign debt crises. UNCTAD has proposed the creation of such a mechanism for a number of years, and the current crisis has again demonstrated that the international financial system would greatly benefit from resolving debt problems in a rapid and equitable manner.

Appendix

External versus fiscal sustainability

1. Debt sustainability exercises for developing countries have traditionally concentrated on external debt. This is because of the paramount importance of the transfer problem and the fact that, until the early 1990s, most external debt of developing countries was public and most public debt of developing countries was external. The crises in the 1990s and 2000s, however, were characterized by the presence of either massive private external debt or a large stock of domestic public debt. In the current environment, about half of the long-term debt of developing countries is issued by private borrowers and more than 50 per cent of public debt is issued domestically.

2. Therefore, when policymakers talk about debt sustainability, they have in mind different definitions of debt. Some think about external debt sustainability and the associated transfer problem; others focus on public debt sustainability and the associated budgetary problem. Some even claim that there is no transfer problem associated with the presence of external private debt and that only external public debt should be of concern.[1]

3. Those who worry about external sustainability are interested in checking whether the country can generate the foreign currency necessary to service the external debt; however, they do not look at whether the different sectors of the economy are able to generate the resources necessary to pay their own debts. Those who worry about public debt sustainability look at the evolution of total public debt without worrying that servicing the public debt may require scarce foreign currency.

4. Both concepts are important, but mixing them up adds confusion to the debt sustainability discussion. The objective of the present appendix is to clarify the differences between different types of debt in terms of the different types of vulnerabilities that they create.

External sustainability

5. The observation that in order to repay its external debt a country needs to earn foreign currency on a net basis was at the basis of economist John Maynard Keynes' 1929 criticism of those who thought that a large external debt was mainly a budgetary problem.

6. The key difference between external and domestic debt is that the ability to generate international currency to pay interest and principal is not directly related to a country's ability to grow or to broaden its tax base. Thus, debt-to-GDP and debt-to-revenues ratios are not adequate measures of a country's ability to repay its external debt. Even the often used debt-to-exports ratio is problematic because a

[1] This latter view is often referred to as the Lawson doctrine and takes its name from a 1988 speech by the British Chancellor of the Exchequer, Nigel Lawson, who, while commenting on the current account deficit of the United Kingdom of Great Britain and Northern Ireland, stated that: "in the past ... United Kingdom current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves and exiguous net overseas assets. The present position could not be more different." Ironically, within one year from this speech, the United Kingdom entered into a deep recession.

large export sector is not sufficient to generate the needed resources if import growth outpaces export growth.

7. Unless a country's external debt is issued in its own currency, the money necessary to cover international obligations on a net basis (i.e., without creating new debt) can only be generated in the presence of a current account surplus. This means that net foreign debt is always a debt that has to be repaid in terms of internationally tradable goods and services.[2]

8. The accumulation of large net foreign liabilities is always the outcome of a persistent current account deficit. Thus, in order to evaluate whether a given amount of debt is sustainable or not, it is necessary to understand the mechanisms that drive the behaviour of the current account. There is evidence that large swings in the terms of trade like those following oil price hikes have immediate and quantitatively significant consequences for trade and current account balances. In the same vein, the reduction of deficits in countries with a sizable share of tradable industrial goods usually goes hand in hand with a devaluation of the nominal and the real value of the currencies affected. Indeed, empirical evidence has shown that changes in the real effective exchange rate have the potential to reduce deficits or to induce swings in the trade and current account from deficit to surplus.

9. In the light of this evidence, a large current account deficit accompanied by a real appreciation and a loss in overall competitiveness is a stronger indicator of unsustainability of the resulting debt than a deficit that is not accompanied by a loss of competitiveness. It is sometimes claimed that developing countries need to accept large inflows and the resulting currency appreciation because they do not possess enough of their own savings and hence need to import capital in order to invest and grow. This line of argument loses persuasive power, however, in a world where developing countries as a whole are both growing and investing at an unprecedented pace and are net exporters of capital.

10. Moreover, as the 2004 *Economic Report of the President of the United States* has put it: "The desirability of positive net capital flows and a current account deficit depend on what the capital inflows are used for. Household borrowing — an excess of household spending or investment over saving — provides a useful analogy. Household debt could reflect borrowing to finance an extravagant vacation, a mortgage to buy a home, or a loan to finance education. Without knowing its purpose, the appropriateness of the borrowing cannot be judged. Similarly for countries, borrowing from abroad can be productive or unproductive." (p. 256). Hence, debt piled up against one or the other activity appears in a different light, and debt sustainability cannot be evaluated on the basis of macroeconomic ratios only.

11. Thus, if a country or a region faces a sharp real revaluation, the concomitant net inflow of capital should not be interpreted as a sign of strength or as the result of the decision of investors to "save" in favour of this region. A sign of strength would be an inflow without an overvaluation. Otherwise, devaluing countries are exporting capital as the necessary complement of their success on the goods market and not as an autonomous resource transfer. As the movement in relative prices is the cause of

[2] In theory, this is also true when external debt is denominated in a country's own currency, but countries that can issue the currency in which their debt is denominated have the option to debase their debt by printing more money.

capital flows, it is inconsistent to complain about the negative effects of the overvaluation and to praise the net capital inflow at the same time.

12. These considerations bear some important lesson for the analysis of external sustainability. In particular, the analogy with calculations of sustainable Government debt is misleading, and we should refrain from following this path of analysis. Any attempt at measuring sustainability needs must include a thorough analysis of the causes of indebtedness.

Fiscal sustainability

13. The term "fiscal sustainability" is often used without having a clear definition in mind. The International Monetary Fund (IMF) defines a policy stance as sustainable if "a borrower is expected to be able to continue servicing its debt without an unrealistically large future correction to the balance of income and expenditure".[3]

14. Formal tests of sustainability tend to be problematic and rather demanding in terms of data requirements. Thus, analysts have developed rule-of-thumb indicators aimed at checking whether current policies can stabilize or reduce a given debt ratio for a given real interest rate, growth rate of the economy and initial stock of debt. This indicator is usually used to analyse the primary surplus that is required to stabilize the debt-to-GDP ratio:

Primary surplus = (interest rate - GDP growth) public debt

There are several caveats that apply to this approach. First, it is not solidly based on any well-specified definition of sustainability, and it mostly focuses on stabilizing a particular debt-to-GDP ratio but does not say anything about the optimality of that ratio. Second, the indicator does not establish necessary conditions for long-run sustainability. There are good reasons why a country may want to run a deficit, and it may be suboptimal to prevent a country from conducting countercyclical policies because these policies would lead to overshooting a fiscal ratio that corresponds to a long-run equilibrium. Third, evaluating the above equation requires assumptions about GDP growth, interest rates and Government expenditures and revenues and implicitly assumes that these variables are exogenous. Most of these variables tend to be endogenous, however, and correlated with one another. It is unrealistic to assume that changes in the primary deficit will have no effect on the interest rate and growth, or that changes in growth do not affect the primary surplus. In fact, deficits incurred to finance public investment should be treated differently from deficits incurred to finance current expenditure. According to current practice, public sector adjustment strategies bundle together current expenditure and public investment. The Rio Group (a permanent mechanism of political consultation and interaction among 19 Latin American countries) put forward a proposal aimed at excluding investment expenditure from fiscal deficit targets. The main argument in favour of this proposal is that, as current expenditure tends to be difficult to adjust (because it is mostly composed of wages and entitlement programmes), investment is the typical adjustment variable when the deficit exceeds the target. In the proposal, the Rio Group argues that the inclusion of investment expenditures in the target budget balance considers every increase in debt as a reduction in Government

[3] IMF, "Assessing Sustainability", policy paper prepared by the Policy Development and Review Department, 28 May 2002, Washington, D.C., p. 4.

wealth, implicitly assigning no value to investment expenditure as an addition to net wealth. The Rio Group would instead favour the adoption of sustainability indicators similar to the one proposed by Buiter in 1985.[4]

15. Finally, the indicator does not take into account a host of factors that characterize the situation of most developing countries and greatly increase uncertainty. In particular, developing countries often have limited capacity to raise taxes (because of a large informal sector), have a volatile revenue base, are subject to large external shocks (both real and financial) that increase the volatility of GDP growth and that of debt service and are characterized by large levels of liability dollarization. All of these elements complicate the management of fiscal policy and greatly increase the difficulty of evaluating sustainability.

Interactions between external and fiscal sustainability

16. There are important linkages between external and fiscal sustainability. The most obvious among these linkages is that about 50 per cent of the external debt of developing countries is public debt and about 50 per cent of public debt of developing countries is issued externally. There are also less obvious linkages. For instance, in a country with no public debt but a large external private debt, the inability of private borrowers to service this debt can lead to a currency and banking crisis, which can then have negative implications on fiscal sustainability. Crisis can also originate in the market for domestic debt, however. The Mexican crisis of 1994/95 originated in the market for CETES, which are domestic currency domestic bonds, and the Russian crisis of 1998 originated in the market for GKOs, which are also domestic currency domestic bonds.

17. The most important interaction between fiscal and external sustainability has to do with the behaviour of the exchange rate; unfortunately, this interaction introduces an unpleasant trade-off. This can be seen by recalling that a real devaluation is a necessary condition for restoring external sustainability, that a large share of public debt in developing countries is denominated in foreign currency and that, as a consequence, a large devaluation can lead to a sudden jump in the debt-to-GDP ratio (for evidence along these lines, see Campos, Jaimovich and Panizza (2006) "The unexplained part of public debt", *Emerging Markets Review*, vol. 7/3, pp. 228-243).[5]

18. Hence, a currency appreciation can simultaneously have a positive effect on fiscal sustainability and a negative effect on external sustainability. If this situation is associated with a rapid deterioration of the current account, however, the improvement in fiscal conditions will only be temporary. This is exactly the problem with the Lawson doctrine, which may lead Governments to ignore their external

[4] Willem Buiter, "A Guide to public sector debt and deficits", *Economic Policy: A European Forum*, vol. 1, pp. 13-79.

[5] This is the reason why the literature on original sin and currency mismatches (Eichengreen, Hausmann and Panizza, "The pain of original sin" (see footnote 9)) argues that external borrowing may be dangerous even in the absence of a transfer problem. As the external debt of developing countries tends to be in foreign currency, a country's ability to repay its debt will depend on the behaviour of the real exchange rate, which in developing countries tends to be very volatile (Ricardo Hausmann, Ugo Panizza and Roberto Rigobon, "The long-run volatility puzzle of the real exchange rate", *Journal of International Money and Finance*, vol. 25/1, pp. 93-124, 2006). There should be no vulnerabilities for countries, like the United States, that can borrow abroad in their own currency (or, better, in a currency they can print).

financial fragility, which will eventually lead to a currency crisis and a fiscal crisis. This trade-off also implies, however, that allowing currency devaluation in the presence of foreign currency debt may lead to a debt crisis and possibly to a costly debt default. This is why some developing countries suffer from "fear of floating".

19. As a change in the composition of public debt and a switch to domestic borrowing can reduce these asymmetries and improve the trade-off discussed above, several developing countries are now retiring external public debt and substituting domestically issued debt. According to some commentators and economists, this switch in debt composition will shield developing countries from future debt crises. While it is true that domestic debt tends to be safer (from the point of view of the issuer), the recent switch from external to domestic borrowing may lead countries to trade one type of vulnerability for another. For instance, countries that are switching from external to domestic debt could be trading a currency mismatch for a maturity mismatch, and excessive domestic borrowing could have a negative effect on monetary credibility and thus lead to high domestic interest rates.[6]

20. These interactions between external and fiscal sustainability point to the fact that domestic debt should be included in debt sustainability analysis exercises. Currently, this is not common practice for at least two reasons. The first reason has to do with the fact that, while domestic debt may have an effect on external sustainability, the vulnerabilities of domestic debt are different from those of external debt. Thus, it would be wrong to simply add up the two types of debt. The second reason is more pragmatic and has to do with the fact that it is hard to find data on the level and composition of domestic debt. Even worse, we do not even have a good definition of domestic and external debt. In fact, while the official definition of external debt focuses on the residence of the creditor (external debt is debt owed to non-residents), most countries classify external and domestic debt based on the place of issuance and the legislation that regulates the debt contract (external debt is debt issued in foreign countries and under the jurisdiction of a foreign court).

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[6] See Guillermo Calvo, "Servicing the public debt: the role of expectations", *American Economic Review*, vol. 78/4, pp. 647-661 (1998).

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Operational activities for development: South-South cooperation for development

Letter dated 16 November 2009 from the Permanent Representative of Qatar to the United Nations addressed to the Secretary-General

I have the honour to transmit herewith the summary report of the Second High-Level Meeting on Oil and Gas Management, held in Nairobi, during the period from 12 to 15 October 2009 (see enclosure).

The Nairobi Meeting was aimed at continuing the collaboration among Southern oil and gas producers begun at the first South-South High-Level Meeting hosted by the State of Qatar in 2007.

At both Meetings, the objective was the sharing of experiences among the petroleum-exporting countries of the South, including those established countries with many years of experience in addition to the new petroleum economies that will emerge as oil and gas exporters in the coming years. Participants at the Nairobi Meeting came from ministries of petroleum and energy, finance and planning, as well as from national oil companies, sovereign wealth funds and other areas of the public sector. Two important objectives of the meeting were identified:

- that the new and established oil and gas producers represented would be able to effectively and fruitfully share experiences and best practices
- that the dialogue would evolve into an ongoing network of South-South cooperation for oil and gas development. This network would then offer assistance to newcomers to the sector as they seek to identify and address their hydrocarbon management challenges and the associated institutional gaps and weaknesses.

The Nairobi Meeting was organized through close collaboration between the Government of Kenya, the United Nations Development Programme Special Unit for South-South Cooperation and the United Nations Development Programme (UNDP) country office in Kenya.

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The participants included senior Government policymakers from ministries responsible for hydrocarbon resources, of finance and of planning, and by representatives of national oil companies. Additionally, several ministers, deputy ministers and members of parliament attended, indicating the high degree of importance attached to the meeting.

The participants discussed candidly the challenges they face, which include negotiating fair and strong contracts, preventing mismanagement of oil and gas revenues and dealing with the "expectations" of Governments, oil companies and, especially, local citizens.

In this regard, participants reiterated the importance of countries managing their oil sector as part of the whole economy, not in isolation.

They endorsed the use of petroleum or sovereign wealth funds as an important, but not sufficient, mechanism for ensuring sound macroeconomic management and agreed that such funds help provide effective long-term use of oil revenues.

Another topic of great interest to both existing and newly emerging oil producers was how quickly and how much "local content" they might introduce.

A great deal of attention was given to the ways in which existing oil and gas producing countries can help emerging producers strengthen their capacities in the sector. Toward this end, many countries held various bilateral discussions, and some existing producers offered to welcome representatives from emerging producers on study tours and other exchanges. The established Southern oil producers appear keen for new producers to better understand how they are managing their hydrocarbon sectors.

In view of the importance of the petroleum sector, the Permanent Representative requests the Secretary-General to kindly have the present letter and its annex circulated as a document of the General Assembly, under agenda item 58 (b).

(*Signed*) Nassir Abdulaziz **Al-Nasser**
Ambassador and Permanent Representative

Enclosure

Government of the Republic of Kenya/
UNDP Special Unit for South-South Cooperation

Second High-Level Meeting on Oil and Gas Management
Nairobi, Kenya
12-15 October 2009

Summary Report

Special Unit for South-South Cooperation
United Nations Development Programme
New York

November 2009

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I. Introduction

This Report summarizes the proceedings of the second South-South High-Level Meeting on Oil and Gas Management that was hosted by the Government of the Republic of Kenya in Nairobi from 12 to 15 October 2009. The Meeting brought together senior officials from 60 countries of Africa, Asia and Latin America as well as representatives of United Nations agencies, other international organizations, local embassies and various Kenyan institutions in the public and private sectors. The Nairobi Meeting was aimed at continuing the collaboration among Southern oil and gas producers begun at the first South-South High-Level Meeting hosted by the State of Qatar in 2007.

At both Meetings, the objective was the sharing of experiences among the petroleum-exporting countries of the South, including those established countries with many years of experience in addition to the new petroleum economies that will emerge as oil and gas exporters in the coming years. Participants at the Nairobi Meeting came from ministries of petroleum and energy, finance and planning as well as from national oil companies, sovereign wealth funds and other areas of the public sector.

The Nairobi Meeting was organized through close collaboration between the Government of Kenya, the UNDP Special Unit for South-South Cooperation and the UNDP country office in Kenya.

At the opening session, presentations were made by invited dignitaries and ranking officials, who commented on the importance of the deliberations and the necessity of sharing experiences and successful strategies in managing the petroleum sector.

The Hon. Kiraitu Murungi, Minister of State for Energy of Kenya, expressed his thanks to the attendees and extended words of welcome to the participants. He noted that in the last five years, Kenya had intensified the search for oil and gas. Neighbouring countries had recently uncovered oil reserves, so it was likely that Kenya would have discoveries of its own soon. The Minister observed that the Meeting was a good opportunity for Kenya to prepare for oil discovery and that Kenya wanted to manage any oil and gas resources for the benefit its people. While oil and gas production had been associated with human rights abuse, tyranny, corruption, civil war, etc., oil and gas could and should be at the centre of Africa's transformation.

Mr. Yiping Zhou, Director of the UNDP Special Unit for South-South Cooperation, welcomed participants, expressed appreciation to all for attending the Meeting, and thanked the Government of Kenya for hosting it. He identified two important objectives of the Meeting:

- that the new and established oil and gas producers represented would be able to effectively and fruitfully share experiences and best practices in making oil and gas work for achieving the Millennium Development Goals and other sustainable development goals, and

- that the dialogue would evolve into an ongoing network of South-South cooperation for oil and gas development. This network would then offer assistance to newcomers to the sector as

they seek to identify and address their hydrocarbon management challenges and the associated institutional gaps and weaknesses.

The Vice President of Kenya, the Hon. Stephen Kalonzo Musyoka, speaking on behalf of the President of Kenya, the Hon. Mwai Kibaki, extended his welcome to the participants and said that Kenya was honoured to be the host of the Meeting. He stated that oil and gas constituted a critical component of economic development and that they would account for two thirds of global energy consumption in 2020. Much of the coming increase in demand for oil would come from developing countries. That was why South-South cooperation was important: countries with expertise in oil and gas production could help other countries, especially in negotiations with outside investors. South-South cooperation was also valuable in the training of students in the petroleum sector, in sharing information in contract negotiations and in macroeconomic management.

The Vice President of Kenya further noted that while the countries present all wanted to encourage investment in the oil and gas sector, it was necessary to consider environmental and social concerns in light of the highest international standards and strike a good balance between maximizing revenue and ensuring environmental protection. He said that the countries of the South would have to work together to stem the adverse effects of climate change.

He also articulated what the Government of Kenya thought were the clear benefits and expected outcomes of the Meeting: (a) to create a common understanding of issues and challenges in oil and gas management that could improve day-to-day management, and (b) to network with counterparts in the oil and gas sectors in other countries to establish ongoing communication and cooperation.

In closing, the Vice President reaffirmed the importance of South-South cooperation and then declared the Meeting officially open.

II. Discussion Themes

Strategic Context of the Nairobi Meeting

The Nairobi Meeting came at a time when most of the participating countries, both the established oil producers and the newly emerging hydrocarbon exporters, had been seriously affected by the global economic and financial crisis, which triggered serious fluctuations in oil prices. In less than six months in 2008, world oil prices approached $150/barrel and then dropped to below $40/barrel. The economic recession demonstrated that energy has become a critical issue on the global agenda from many different perspectives – from immediate environmental concerns, to development needs, to the growing attention to long-term problems of global warming and the decreasing availability of petroleum and gas reserves.

At the same time, while the current global economic and financial crisis may have affected these trends and concerns, it has not altered the fundamental challenges confronting existing and new oil and gas producers of the South. Over the long term, the new oil boom for developing countries

represents the potential for great opportunity or for great peril – the "curse of oil" as it is often called in the international media.

History suggests that having petrodollars has not necessarily helped developing countries to reduce poverty; in many cases, petrodollars have actually exacerbated poverty conditions and worsened income inequality. Thus, oil revenues are neither a necessary nor a sufficient condition for sustainable and equitable economic development. Prudent investments and vigilant attention to sound macroeconomic and governance policies are common elements found in successful oil- and gas-exporting countries.

As the current global recession demonstrates, even successful hydrocarbon economies must continually adjust and calibrate their policies in the face of changing international market conditions.

Major Topics Discussed

Based on earlier communications from the invited participants and the short duration of the Meeting, the decision was taken to concentrate on a small number of topics for the Meeting so as to allow for more in-depth discussion and exchange of experiences. Topics were introduced by invited resource persons or by country delegates who shared the experiences or perspective of their particular country. On the fourth day of the Meeting, break-out sessions were convened to allow for further debate and exchange of views on the points and issues raised in the earlier plenary discussions. The chosen topics were:

- Managing and meeting expectations of national governments, international oil companies and local citizens;
- Options and models of petroleum funds (sovereign wealth funds);
- Fiscal policy for oil and gas revenue management;
- Financial implications of oil and gas contracts;
- Expanding "local content" in the development of the hydrocarbon sector;
- Issues in the utilization of joint development zones for shared resources;
- Corporate social responsibility;
- Environmental management best practices; and
- Carbon markets and trading in the context of oil- and gas-producing countries.

Given below are some of the highlights and key points on these topics that emerged during the plenary discussions and in-depth breakout sessions.

Managing and Meeting Expectations of National Governments, International Oil Companies and Local Citizens

The discussion underlined the importance of understanding the interplay between oil investors and the host-country government as well as local populations. Each stakeholder has different requirements and expectations that must be understood. In establishing contracts, the objectives of the host country and the oil investors often vary; similarly the host country and the investors have different sets of requirements to fulfill.

Governments seek to enhance the development of their petroleum resources and reserves as the first priority in their efforts. There is thus a natural wish to increase access to modern technology and promote technology transfer. Governments hope to improve their capacity for institutional management and maximize revenue from resource development. The majority of the governments (with very few exceptions) are attempting to encourage the flow of private-sector investment and to establish long-term relationships with international oil companies. When countries are interested in attracting investors, there are a number of important factors that can make a country more attractive for investment: a history of honouring contracts, political stability in-country, an open economy, a technically competent workforce and an efficient regulatory system.

During the discussion, it was noted that the objective of investors is the diversification of the asset base through additions to reserve inventory as well as the minimization of capital and operating costs and, at the same time, the maximization of profit and operational freedom. All operating companies are concerned with the issues of transparency, fairness and competitiveness in the resource-rich countries where they are operating. It is a natural aspiration towards a reasonable limitation to liability, in other words, risk proportional to reward. Foreign investors are generally concerned about three primary issues: (a) the scope of government involvement in oil and government's financial capabilities in the sector; (b) the degree of foreign ownership of oil in the country; and (c) the past degree of success of foreign investment in the country.

It was pointed out that national oil companies, in contrast with corporate oil companies, may have different obligations and that even among national oil companies, there is a great deal of variation in policy and management. National oil companies generally espouse three principal objectives on behalf of their respective governments: (a) to reduce dependence on multinationals for their oil supplies; (b) to provide the government with an "inside window" on the petroleum industry to enable its bureaucracy to judge the performance of the multinationals in the specific country; and (c) to assure continuity of supply both at the crude oil producing, refining and marketing stages at home.

The discussion included examples from countries in the Caspian Region: BP in Azerbaijan, Burren Energy in Turkmenistan and KazMunaiGaz in Kazakhstan. In all three countries (and no doubt for other oil-producing regions as well), there are two fundamental issues that must be confronted: the impact of hydrocarbon resources on the economies and economic development of the Caspian countries, and the management of the hydrocarbon wealth. Both these issues have a critical

importance for the region, but especially in the light of managing expectations between companies and governments.

Options and Models of Petroleum Funds (Sovereign Wealth Funds)

Petroleum funds – or sovereign wealth funds as they are now often called – are becoming a common macroeconomic instrument in oil revenue management. This session examined the best international practices in petroleum fund management and key principles for sound management of petroleum revenues, highlighting such principles as maintaining clear lines of responsibility and ensuring transparency. It should be understood that a petroleum fund is no substitute for sound fiscal management and that a poorly designed fund can do more harm than good.

Features of successful funds include fund management as an integrated part of the fiscal policy and macroeconomic framework, good governance, transparency and a clear separation of roles of the overall owner of the fund, usually the Government, and the operational management responsible for implementing the investment strategy. A petroleum fund can act as a buffer against volatile petroleum production and prices, be a useful savings instrument to avoid the "petroleum curse", and ensure that both current and future generations can benefit from the petroleum revenues. The Santiago Principles for sovereign wealth funds were cited as a sound approach potentially achievable by countries at all levels of development.

During the discussion, two case studies were presented of successful petroleum funds that have been put into operation in the last few years – in Timor Leste and Azerbaijan. In both cases, the funds were already managing several billion dollars in assets and had had notable success in having independent management and high fiduciary standards. Timor Leste's Petroleum Fund was set up in 2005 and is already valued at $5.1 billion, over 10 times the non-oil gross domestic product of the country. The State Oil Fund of Azerbaijan was established in 1999 and now has deposits in excess of $12 billion. In both instances, deposits were being invested in global markets to maximize returns within accepted risk parameters. The Azerbaijan Fund, for example, earned some 3.5 per cent on its investments during the past recessionary year (2008), surpassing earnings of many private investment firms. In addition, both Funds were managed in accordance with the principle of "saving for future generations" so that only a very small portion of the money was being disbursed in any given year.

Fiscal Policy for Oil and Gas Revenue Management

In this discussion, several considerations were mentioned as a guide to sound fiscal policy in developing countries with an emerging oil and gas sector. These include the need for fiscal sustainability and sound governance as well as the importance of intergenerational equity as a core principle of fiscal policy. Fiscal policymakers also need timely information about oil and gas developments to make sound decisions.

The discussion focused on key guidelines in formulating fiscal policy:

- A sustained and high fiscal deficit is detrimental to long-term growth; all countries must move towards a sustainable fiscal policy for oil and gas revenues.
- Public debt should be kept at a sustainable level.
- The economy should not rely solely on hydrocarbons; it must be diversified.
- It is important to carefully integrate policies for a country's oil fund with government budgets and expenditures and to ensure transparency.

Five success factors were noted for good fiscal policy in the context of anticipated oil and gas revenues: (a) aligning fiscal, economic and energy policies; (b) incentive-based public expenditure systems to improve the quality of public spending; (c) the promotion of domestic value added; (d) economic and political reforms; and (e) openness and transparency.

The discussion highlighted several key fiscal policy challenges for the oil- and gas-exporting countries in the years ahead:

- The prime fiscal and economic challenge will be consistency in pursuing efficient and effective management of public hydrocarbon wealth to serve as a strong anchor for achieving sustainable economic freedom and livelihoods in an environment currently characterized by hydrocarbon-induced environmental degradation, low living standards, large-scale unemployment and social conflict.
- Clearly, the fiscal policy questions in oil- and gas-producing and exporting countries are not only complex but also politically controversial as they involve a set of economic, social, political and environmental goals that are not necessarily mutually reinforcing.

Financial Implications of Oil and Gas Contracts

This session looked at some of the implications and unintended consequences of oil and gas contracts for investors/operating companies and national governments. A key theme of the discussion was the need to "be aware of ambiguous or missing terms" in contracts and the importance of "doing it right the first time". Features of advanced petroleum contracts were examined, including progressive fiscal terms, "R" factors, rate-of-return features, windfall-profit taxes (price caps), effective royalty rates (how soon governments receive a share of revenue), and incentives for investors to keep costs down (savings index). The session also focused on the real need for local content and infrastructure provisions. A country's contract-negotiation leverage is constrained, however, by boundary conditions, "prospectivity" (the chance of actually finding recoverable oil and gas at a profit), market access, and, for some counties, the expected economic return from the hydrocarbon assets if these resources are costly to extract.

Key points touched upon in the discussion included the following:

- Sustainable agreements must be progressive so that the government's share of the profits (per cent of profits or take) increases when profits increase. Most systems today are regressive.

- Sustainable agreements must also provide governments with high, effective royalty rates (early money) – if governments need them (some do not).

- Sustainable agreements must also provide the investors with an opportunity to share in the profits since the latter do take on considerable risk and fiscal terms today are very demanding for investors.

- If agreements are not perceived to be fair – by any party – then they are inherently unstable.

- At the same time, there are inherent risks in renegotiating and or changing terms of contracts just prior to a licence round, suggesting the need for very careful analysis before contract signing (allocation processes and licensing).

- It is also a problem if discoveries are made and there is a long wait before production commences. This is known as "warehousing". Nothing is more frustrating for a government than having a discovery that is not developed for decades. The investors are capable of waiting until the time is right for them, but it is difficult for governments to implement "use-it-or-lose-it clauses as part of contract negotiations.

- Today the field size of discoveries of oil is going down, which has implications for the preparation of oil and gas agreements. Therefore, governments, especially those of emerging oil- and gas-producing countries, need to fully understand the time line and financial implications of bringing oil and gas to full commercial exploitation.

Expanding "Local Content" in the Development of the Hydrocarbon Sector

Local content is concerned with using the opportunities and advantages offered by multinational oil companies and their international contractors to jumpstart local capabilities and accelerate local, regional and national development in specific priority areas. Participants at this session agreed that although local content is primarily about access to oil and gas contracts for local suppliers, it should be seen in a more holistic and integrated way. An integrated policy will take into consideration available local industrial capacities, technical skills, infrastructure facilities and fiscal regimes in fixing local-content targets in field development projects. It was also agreed that the whole value chain should be studied carefully to decide where value extraction would provide the maximum benefit to a country's economy. One country might find it better to concentrate on maximizing value extraction in field development projects, another might focus on downstream activities such as refining, and yet another might maximize value extraction in gas-to-wire projects.

From a policy perspective, it is the government's responsibility to plan the direction in which to move so the country must craft the legal framework that best captures local content, taking into consideration price competitiveness, project delivery and transparency. At the same time, while government has a legitimate role in the formulation of local-content strategy, local-content objectives can be constrained by weak government policymaking, weak institutions, and equity issues associated with natural-resource-based economies.

Nonetheless, local content in the oil and gas sector can stimulate infrastructure investments, rural development, and the growth of linkage sectors such as steel, marine, electricity, banking and insurance, as well as new small and medium-sized enterprises. In conclusion, factors that contribute to successful local-content provisions include a good understanding of the oil and gas value chain and the supply chain on the one hand and the ability of national oil companies to encourage collaboration (not coercion) with international partners on the other. For long-term sustainability, a sound business environment and careful attention to social issues including human capital investment are indispensable.

Legal, Policy and Practical Issues Arising from Joint Development Agreements

This session examined the legal basis and current examples of joint development agreements for the management of overlapping claims areas and transboundary petroleum resources. Broadly speaking, "joint development" occurs when two or more States that have legitimate rights to a common hydrocarbon deposit or field formally agree to cooperate in exploring and exploiting the common deposit according to a pre-arranged share of the revenues to be gained from such exploitation. It was noted that the application of the joint development principle between neighbouring States, especially developing countries in Africa, Asia and South America, was much to be preferred to undertaking expensive inter-State litigation or, even worse, the threat or use of force to secure access to these shared resources.

It was noted that semi-enclosed sea areas are the most common location for such joint ventures, such as the North Sea, the Persian Gulf and maritime Southeast Asia. More recently, State practice in joint development has also taken place in the Caribbean and off the coast of West Africa. Three models of joint development have been utilized to manage overlapping claims areas and transboundary deposits:

- Model I: one State exploits resources and pays the other State a proportion (usually half) of the proceeds. Examples of these agreements include the Bahrain-Saudi Arabia, Qatar-United Arab Emirates and Islamic Republic of Iran-Sharjah agreements.

- Model II: the States agree to require their individual licensees to enter into a joint operating agreement for the exploitation of shared deposits whether in an overlapping claims area (e.g., the Malaysia-Viet Nam agreement in the South China Sea) or lying across the already delimited boundary line (e.g., the United Kingdom-Norway and United Kingdom-Netherlands agreements in the North Sea).

- Model III: a joint institutional framework is established to facilitate cooperation in the exploitation of shared resources within an overlapping claims area (e.g., the Malaysia-Thailand, the Australia-Timor Leste, and the Guinea-Bissau-Senegal agreements).

It was also noted that within the joint development models described above, there were many examples where the government revenue-sharing split does not necessarily need to be equal. The revenue-sharing proportions can reflect the physical, political and economic perspectives of the State parties involved in the joint development agreements, depending on their specific circumstances. For example, the Australia-Timor Leste agreement provides that 90 per cent of the proceeds go to Timor Leste and 10 per cent to Australia.

Common elements in all three models of joint development agreements are now well documented and could provide a basis for negotiations between States for possible future joint development agreements. International law and jurisprudence in this area are growing, with Articles 74(3) and 83(3) of the 1982 United Nations Convention on the Law of the Sea providing a significant basis in law for the negotiation of such joint development agreements.

Corporate Social Responsibility

Corporate social responsibility (CSR) is concerned with integrating social and environmental responsibilities into the business model of extractive-industry companies. It is growing in global importance because companies now see it as good business for financial, operational and strategic reasons. CSR investments may represent 3 to 5 per cent of the total corporate investment in a project at the production phase. Governments should address social and environmental issues early in the negotiation and planning phases of oil development and proactively negotiate CSR policies and practices with oil companies at an early stage. It is also important, from a government perspective, to enact laws and regulations that backstop CSR behaviours based on clearly articulated national objectives.

During the discussion, it was pointed out that the number of stakeholders and interested parties in CSR has grown considerably. No longer are social (and environmental) issues of bilateral concern only to the government and the oil company or consortium involved. Instead, the number of stakeholders and constituent groups has increased substantially, now requiring much higher levels of proactive participatory decision-making and transparency. This situation has arisen as the result of increasing scrutiny by media and local non-governmental organizations of oil operations in developing countries in addition to more vocal demands by local communities that expect to be involved in the decisions that affect their lives and livelihoods.

In viewing CSR from the perspective of the private sector, it was pointed out that corporations should not view CSR as an expenditure but rather as an investment with a return on investment. One of the primary returns of CSR is reduced risk in operations. CSR also increases an oil company's political capital with host governments.

In looking at CSR, it is important to recognize that the top priority of oil companies is to achieve returns on their investments. Oil companies are not philanthropists so they as well as governments need to find a middle ground in viewing CSR as falling between pure philanthropy and pure business. A long-term perspective on government-company relations can build mutual trust and confidence.

Environmental Management Best Practices

In this discussion of changing best practices for environmental management, several instruments were highlighted. These included legal registries that provide companies with a clear list of laws and regulations with which to comply; environmental screening of projects to ensure that all of the stakeholders focus on the key issues; public involvement aimed at improving public understanding of the proposed project and to obtain the input of stakeholder issues and concerns; environmental impact assessments to clearly define and understand the potential positive and negative impacts of new developments; and environmental and social management plans to prevent, mitigate and monitor both positive and negative impacts.

An important element of environmental best practices is to recognize and understand the range and role of different stakeholder interests involving governments, communities and non-governmental organizations as well as the oil and gas companies. Best practices are increasingly becoming the norm for many companies. More broadly, an "environmental and social management system" is seen as an increasingly important way to address environmental and social issues arising from extractive industries. The 2006 Equator Principles, adopted by the financial industry to manage social and environmental issues in project financing, were discussed as a possible framework to guide best practices in the oil and gas industry.

Based on a review of best practices in environmental management for the oil and gas sector, the following best practices were highlighted for implementation in developing countries: strategic environmental impact assessment, cumulative environmental impact, health environmental impact assessment, efficient regulatory environment, corporate social responsibility (CSR) for companies, capacity-building for government, institutional coordination, information and communication for local communities, environmental and social action plan, and revenue sharing.

Carbon Markets and Trading in Oil- and Gas-producing Countries

The discussion of carbon markets and climate change began by noting that the science of climate change is no longer in dispute and that, although many policymakers, academics and activists agree with the prevailing science that reducing carbon dioxide (CO2) emissions to keep global temperatures from rising by 2 degrees Celsius is essential in the quest to avoid the catastrophic effects of climate change, the numbers are no longer the driving force. The debate is not about whether there will be climate change effects but when they will occur, who will be impacted and what can be done to mitigate and adapt to the effects. It was further noted that as much as the oil and gas sector is a potential cause of greenhouse gas emissions and the resulting climate change impacts, it is also a potential solution that provides oil- and gas-producing countries and the entities operating in them with significant opportunities.

In the context of a carbon-constrained economic future, there are likely to be significant opportunities for oil- and gas-exporting developing countries. The discussion highlighted six areas of opportunity:

- Integrate climate policies into broader development policies (to make it easier to overcome barriers);
- Develop investment-conducive legal and regulatory infrastructure to attract technology and assist in adaptation;
- Use voluntary agreements to accelerate the application of the best technology available;
- Engage in and facilitate the development and diffusion of new technologies (including carbon capture and storage);
- Take advantage of international financial institutions and private investment for the application of improved and proven technology;
- Use a portion of oil and gas revenues to counteract the effects of the industry on climate change and thereby assist in adaptation and mitigation.

As part of the discussion, a case study was presented on climate change and carbon trading in developing countries such as South Africa, which has used Clean Development Mechanism (CDM) opportunities such as access to clean energy to its benefit. Some of the CDM projects in South Africa have resulted in benefits such as job creation, facilitation of technology and skills transfer, and improvement of housing. It was also recognized that a number of countries, especially in Africa, have not been able to take advantage of CDM opportunities because of weak institutional arrangements and carbon price risks.

Other challenges highlighted include the following:

- There is some reluctance on the part of private investors to invest in Africa.
- The CDM procedures and modalities needed to bring projects to implementation are complex and lengthy in terms of time.
- There are many host-country constraints, such as weak institutional capacity and unfamiliarity with carbon markets and carbon offsetting.
- Costs for registration, verification and monitoring emission reductions are significant.
- There is the potential for time-consuming, confrontational debates over political acceptability (eligibility, approval processes).

Capacity-building for Effective Oil and Gas Management

One of the main agenda items and discussion topics during the course of the four-day Meeting was an examination of the critical need for accelerated capacity-building for the newly emerging oil and gas economies. At the first South-South High-Level Meeting on Oil and Gas Management, held in Doha in 2007, the participants noted that shortfalls and gaps in institutional capacity were the most significant challenge facing new oil- and gas-producing countries. Three of the conclusions from the Doha Meeting touch upon the institutional and management problems confronting the newly emerging oil and gas economies and why so much attention was devoted to this topic in Nairobi:

- Shortfalls and gaps in institutional capacity represent the most fundamental and underlying challenge that most new oil- and gas-producing States face.

- Considerable attention is necessary to address the institutional and capacity gaps well in advance of the actual receipt of petroleum revenues.

- Many new oil and gas producers currently have neither the financial nor the technical means to increase their internal institutional capacity fast enough to keep up with the expansion of their hydrocarbon sector.

Given the critical importance of capacity-building, the Special Unit for South-South Cooperation launched a South-South oil management capacity-building project during the Meeting that is designed specifically for the newly emerging oil and gas producers. The project will be financed through a Hydrocarbon Trust Fund with a target endowment of $8 million. During the Nairobi Meeting, contributions for the Trust Fund were received from the Governments of Kenya ($200,000), Liberia ($200,000) and Suriname ($100,000) as well as from the UNDP Special Unit for South-South Cooperation ($1 million). In addition, the Government of Kenya offered to host the project secretariat, which will oversee the Trust Fund and oil management capacity-building project.

One of the key objectives of the capacity-building project will be to provide scholarships for over 1,000 students to study at Southern universities that offer specialized training in petroleum engineering, resource economics, environmental management and other critical tasks needed by the newly emerging oil and gas producers. Apart from the scholarships, the project will also fund short-term seminars and workshops for senior- and mid-level policymakers and mangers that will be hosted at these same Southern universities.

As of this writing, the Special Unit is actively seeking additional contributions to the Hydrocarbon Trust Fund and anticipates launching the project in January 2010.

III. Meeting Outcomes and Major Recommendations

On the last day of the Meeting, participants turned to an examination of ways to foster ongoing mechanisms and opportunities for South-South collaboration so as to share experiences and best practices in hydrocarbon management. There was consensus that ongoing exchanges of experiences between the existing and emerging oil- and gas-producing countries of the South have proven to be beneficial and effective in facilitating improved hydrocarbon management for the new oil- and gas-producing States. At the conclusion of the Meeting, a draft "Nairobi Statement on South-South Cooperation for Effective Oil and Gas Management" was distributed for discussion. Based on comments received, the draft was revised and a final version of the Nairobi Statement is included as an annex to this Report.

The following are the key recommendations that emerged from the Meeting aimed at helping the newly emerging oil and gas producers to manage their hydrocarbon sectors more effectively:

- Provide support to help new oil and gas producers to fully understand the financial implications of various contractual components, including allocation of acreage (licensing rounds), renegotiations, arbitration/litigation and enhanced oil recovery;

- Research policy guidelines on approaches and best practices to address the local content challenge in a cost-effective and equitable manner that promotes the local economy, expands the number of local businesses and creates value-added jobs in the hydrocarbon sector;

- Compile best practices on managing expectations among national governments, international oil-company partners and local populations. This is seen as a key requirement especially for the newly emerging oil and gas producers when the general population anticipates unrealistic changes in their livelihoods due to oil revenues;

- Establish a set of carbon principles for oil and gas companies that are consistent among the regions and include explicit guidance on due diligence for climate change-related impacts of projects and their mitigation by oil and gas companies;

- Implement the 2006 Equator Principles adopted by financial institutions as a possible framework to guide best practices in environmental and social management in the oil and gas industry; and

- Reconvene a follow-up meeting within one year to report on progress achieved through the South-South exchange of experiences and the capacity-building project.

At the closing session of the Meeting, the Minister of Energy of Kenya, the Hon. Kiraitu Murungi, made concluding remarks and thanked the participants. He noted that the Meeting was important for Kenya as the country would be beginning to drill shortly and it was very optimistic that oil would be found. Therefore, even though Kenya was not yet an oil-producing country, it was important to learn from the experiences of other countries of the South and he thanked UNDP for the timely Meeting.

Before concluding, the Minister of Energy introduced the Minster for Planning and Vision 2030, the Hon. Wycliffe Ambetsa Oparanya.

Minister Oparanya then read the closing remarks on behalf of the Prime Minister of Kenya, the Hon. Raila Oginga Odinga, in which the Prime Minister said that he had been informed that the Meeting had covered a wide range of topics such as fiscal policy and oil revenues, financial implications of contract negotiations, local content, joint development zones, environmental and social issues in hydrocarbon management, and climate change and carbon markets. The Prime Minister commended the participants for their commitment and hard work to come up with constructive and practical recommendations. He further stated that the deliberations demonstrated the importance of creating ongoing means of collaboration and interaction between and among the countries represented in Nairobi. He expressed the hope that the participants would continue the discussion and exchange of experiences that had begun two years ago in Qatar. The Prime Minister concluded by thanking UNDP and the Special Unit for South-South Cooperation for their support in organizing the Meeting.

Yiping Zhou, Director of the Special Unit for South-South Cooperation, congratulated the participants on their active involvement and strong sense of collaboration during both the formal meetings and those informal times over coffee, meals and evening gatherings when there were occasions for discussion and sharing of experiences. He said that those kinds of interaction are what lie at the heart of South-South cooperation and demonstrate that the problems and challenges were, in fact, common to most, if not all, of the participants gathered in Nairobi.

Mr. Zhou ended by expressing his official and personal thanks to the Government of Kenya for its strong support and incredible warmth in hosting the Meeting.

The Minister of Natural Resources of Suriname, the Hon. Gregory Rusland, then took the floor to thank the Government of Kenya and UNDP, on behalf of all the participants, for hosting and organizing the second High-Level Meeting. He expressed his appreciation for the opportunity to share experiences with other oil and gas producers from the South and hoped that there would be a chance for the participating countries to meet again.

ANNEX

NAIROBI STATEMENT ON SOUTH-SOUTH COOPERATION FOR EFFECTIVE OIL AND GAS MANAGEMENT

Nairobi, Kenya, 15 October 2009

Introduction

From 12 to 15 October 2009, the Republic of Kenya hosted the second South-South High-Level Meeting on Oil and Gas Management, which brought together senior officials from 60 countries of Africa, Asia and Latin America as well as representatives of United Nations agencies, other international organizations, local embassies and various Kenyan institutions in the public and private sector. The Nairobi Meeting was aimed at continuing the collaboration among Southern oil and gas producers begun at the first South-South High-level Meeting hosted by the State of Qatar in 2007.

In both Meetings, the objective was the sharing of experiences among the petroleum-exporting countries of the South, including those established countries with many years of experience in addition to the new petroleum economies that will emerge as oil and gas exporters in the coming years. Participants at the Nairobi Meeting came from ministries of petroleum and energy, finance and planning as well as from national oil companies, sovereign wealth funds and other areas of the public sector.

The Nairobi Meeting was organized through close collaboration between the Government of Kenya, the UNDP Special Unit for South-South Cooperation and the UNDP country office in Kenya.

Discussions and Conclusions

Over the course of four days of presentations and deliberations, participants discussed a number of topics that were of relevance to oil and gas management. These included:

- Managing and meeting expectations of national governments, international oil companies and local citizens;

- Options and models of petroleum funds (sovereign wealth funds);

- Fiscal policy for oil and gas revenue management;
- Financial implications of oil and gas contracts;
- Expanding "local content" in the development of the hydrocarbon sector;
- Legal, policy and practical issues arising from joint development agreements;
- Corporate social responsibility;
- Environmental management best practices;
- Carbon markets and trading in oil- and gas-producing countries.

The Special Unit for South-South Cooperation used the opportunity of the Meeting to reach agreement with the participating countries on the need for a capacity-building project aimed at supporting the newly emerging oil and gas producers in overcoming institutional constraints in order to successfully manage the oil and gas sector. Shortfalls and gaps in institutional capacity represent the most fundamental and underlying challenge facing most new oil- and gas-producing States. The project was deemed to have critical importance because many new oil- and gas-producing countries do not currently have the financial or technical means to increase their internal institutional capacity fast enough to keep up with petroleum exploration and production.

The project will be funded through a new South-South Hydrocarbon Trust Fund with an endowment targeted at $8 million. During the course of the Meeting, financial commitments to the Trust Fund were received from the Governments of Kenya, Liberia and Suriname, along with an offer by the Government of Kenya to host the project secretariat.

In the course of the four days of discussion, there was widespread agreement on several issues, including:

- The extreme price fluctuations in world petroleum markets and the current global financial crisis have had a severe impact on existing oil and gas producers and slowed the pace of exploration and development for most of the newly emerging oil and gas producers.
- These economic impacts have only heightened the challenge for both existing and new petroleum-exporting countries to ensure that oil revenues are used to improve the lives of their citizens and to achieve sustainable socio-economic development.
- It is important to ensure that the oil and gas sector is not managed in isolation from the wider economy since long-term success can be achieved only when both the oil and gas and other sectors are managed well.

- There is still an ongoing need for newly emerging oil-producing governments to be better equipped to negotiate contracts with international oil companies and to better understand the financial and revenue implications of different contractual approaches or components.

- Petroleum or sovereign wealth funds represent important, but not sufficient, mechanisms for ensuring sound macroeconomic management and providing for the effective long-term utilization and allocation of oil revenues.

- Accelerating the pace at which local content is included in government contracts continues to be a priority for existing and newly emerging oil and gas producers. Local-content policies must encourage knowledge transfers and the formation of human capital in the context of promoting the growth of local companies and service providers.

- The newly emerging hydrocarbon governments need to take a much more proactive approach to corporate social responsibility and environmental management by setting and expecting their foreign partners to meet the highest internationally accepted standards.

- Oil-producing States have both a special obligation and a unique opportunity to address climate change and use carbon markets to achieve wider development goals and help their citizens to reduce the impacts of climate change at the community level.

Recommendations

The participants expressed their appreciation for the opportunity to share their experiences on a wide range of topics that would facilitate more effective management of the oil and gas sector. They further indicated their support for the new oil and gas capacity-building project that would create additional opportunities and new mechanisms for the ongoing exchange of experiences. In this regard, the participants further endorsed the following recommendations for more in-depth review and analysis:

- Provide support to help new oil and gas producers to fully understand the financial implications of various contractual components, including allocation of acreage (licensing rounds), renegotiations, arbitration/litigation and enhanced oil recovery;

- Research policy guidelines on approaches to addressing the local content challenge in a cost-effective and equitable manner;

- Compile a compendium of best practices on managing expectations among national governments, international oil-company partners and local populations;

- Establish a set of carbon principles for oil and gas companies that are consistent among the regions and include explicit guidance on due diligence for climate change-related impacts of projects and their mitigation by oil and gas companies;

- Implement the 2006 Equator Principles adopted by financial institutions as a possible framework to guide best practices in environmental and social management in the oil and gas industry; and

- Reconvene a follow-up meeting within one year to report on progress achieved through South-South exchanges of experiences and the capacity-building project.

At the close of their deliberations, participants unanimously expressed their gratitude to the Government of Kenya for hosting the Meeting and for the quality of the services and facilities and to the people of Kenya for their warm hospitality.

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Letter dated 30 November 2009 from the Permanent Representative of Greece to the United Nations addressed to the Secretary-General

I have the honour to enclose herewith the joint statement of their Excellencies, the Prime Ministers of Greece, Albania and the former Yugoslav Republic of Macedonia (see annex I), on the occasion of their meeting in Prespa, Greece, on 27 November 2009, together with a letter signed the same day by the three Prime Ministers (see annex II).

I should be grateful if the present letter and its annexes could be circulated as a document of the General Assembly under agenda items 53 (a) and (d).

(*Signed*) Anastassis **Mitsialis**
Permanent Representative
Ambassador

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Annex I to the letter dated 30 November 2009 from the Permanent Representative of Greece to the United Nations addressed to the Secretary-General

27 November 2009

We, Prime Ministers George Papandreou, Sali Berisha and Nikola Gruevski, of the three States sharing the Prespa Lakes Basin, met today, 27 November 2009, at Pili, Municipality of Prespa, Greece,

Taking into account the Declaration of the Prime Ministers of our three States of 2 February 2000 on the Creation of the Prespa Park and the Environmental Protection and Sustainable Development of the Prespa Lakes and their Surroundings;

Considering that the Prespa Lakes and their surrounding catchment basin are a unique natural area whose geomorphological, ecological, biodiversity and cultural significance is of international importance, while constituting a fragile and vulnerable ecosystem that is threatened, inter alia, by various human activities, the effects of which are further aggravated by the impacts of climate change;

Recognizing their common responsibility for the conservation of the Prespa ecosystem, its services and functions, as a basis for the sustainable development of the area, including its environmental conservation and viability, economic development and the sustainable livelihoods of its inhabitants, constituting a catalyst for stability and prosperity of the area;

Aware that individual actions of countries are not sufficient to bring about conservation of the ecosystems of Prespa and its cultural heritage, and thus wishing to enhance our transboundary cooperation, at all levels of administration as well as through the effective cooperation of non-governmental organizations and of civil society organizations; and

Taking into account the relevant provisions of international legal instruments in force in the field of environmental protection to which we are parties or signatories, the bilateral agreements in force between our three countries concerning cooperation in the field of environmental protection and sustainable development as well as the fact that only one of the three countries is a member State of the European Union;

We agree on the following:

1. We recognize the valuable experience gained from the trilateral cooperation in the framework of the Prespa Park since 2000, through the operation of the interim Coordination Committee and its secretariat and we acknowledge the valid elements included in the Strategic Action Plan for the Sustainable Development of the Prespa Park elaborated in this framework, as a sound foundation for our further transboundary cooperation.

2. In order to ensure an integrated protection of the ecosystem and the overall sustainable development of the Prespa Lakes Basin, we look forward to the signing on 2 February 2010, the tenth Anniversary of the creation of the Prespa Park and World Wetlands Day, of an agreement between our three countries, with the European Commission as a fourth party, on the protection and sustainable development of the Prespa Lakes Basin, as an expression of our willingness to fully operationalize the Declaration of the Prime Ministers of 2 February 2000.

3. In this context, and based on territorial integrity, mutual benefit and good faith, we commit to further promote our bilateral and multilateral cooperation so as to:

- Enhance integrated water resources management, with emphasis on both quality and quantity aspects of surface and ground waters encompassed in the Prespa Lakes Basin system, including the development of integrated transboundary river basin management plans, according to existing international and European Union standards, frameworks and commitments.
- Prevent, control and reduce pollution affecting the Prespa Lakes Area, based on best available techniques.
- Protect soil resources from, inter alia, erosion and degradation.
- Protect, conserve and promote the sustainable use of biodiversity in the Basin through, inter alia, control of the adverse effects of human and economic activities on natural resources in the Basin, according to the principles of sustainable development.

4. To this end, we commit to further expedite our means of cooperation so as to develop joint plans, strategies and measures, aiming at an effective integration of the environmental considerations into other sectors and economic activities in the Prespa Lakes Basin such as agriculture, tourism, spatial planning, fisheries, forestry, infrastructure development and energy, biodiversity conservation and protected areas management within the Basin.

5. Moreover, we acknowledge cooperation on capacity-building and exchange of experiences, information and know-how as an integral part of our common efforts, aiming, inter alia, at supporting the process of translating local needs into concrete and bankable projects, through peer reviews and assessments, focusing on increased coherence, ownership, alignment and harmonization of related actions.

6. Taking into account that climate change poses serious threats to water resources and ecosystems, such as the Prespa Lakes, aggravating even further their vulnerable conditions and hampering achievement of the above-mentioned objectives, in view of the Fifteenth Conference of the Parties to the United Nations Framework Convention on Climate Change (COP15) to take place in Copenhagen, in December 2009, we commit to joint efforts so as to contribute to a strong and fair agreement in Copenhagen for combating climate change, compatible with sustainable economic growth and prosperity of livelihoods.

7. Along these lines, we emphasize the need to continue developing bridges between our countries so as to improve our knowledge base and responses to common challenges through feasible, ambitious, firm and concrete actions.

8. In this respect, we strongly support an agreement in Copenhagen that will give due emphasis to adaptation aspects, inter alia, through the creation of a framework of action on adaptation as an integral part of the Copenhagen outcomes, that will allow building resilience and defence measures to increased climate variability and climate change, through the application of holistic approaches at the catchment area, for the protection of vulnerable ecosystems and their functions and services, such as the Prespa Lakes, until and beyond 2012.

9. We will spare no efforts so that the Prespa Park becomes and remains a model of its kind as well as an additional reference for peaceful collaboration among our countries.

Annex II to the letter dated 30 November 2009 from the Permanent Representative of Greece to the United Nations addressed to the Secretary-General

27 November 2009

We, Prime Ministers George Papandreou, Sali Berisha and Nikola Gruevski, of the three countries sharing the Prespa Lakes area, met on 27 November 2009, at Pili, Greece, and agreed to further promote our cooperation on environmental issues.

In this context, we look forward to the signing on 2 February 2010, the tenth anniversary of the creation of the Prespa Park and World Wetlands Day, of an agreement on the protection and sustainable development of the Prespa Park area.

We recognize our common responsibility for the conservation of the Prespa ecosystem as a basis for the sustainable development of the area, environmental development and sustainable livelihoods of its inhabitants, which constitutes a catalyst for stability and prosperity in the region.

We believe that our joint action is setting a unique example, as the Prespa Park constitutes the first transboundary protected area in south-eastern Europe and will contribute to increasing awareness of the importance of coordinated policies on environmental issues in our region and beyond.

By our initiative, we wish to demonstrate our support to your efforts for an agreement at the Conference of the Parties to the United Nations Framework Convention on Climate Change, which will take place in Copenhagen in December 2009.

(*Signed*) Sali **Berisha**
Prime Minister

(*Signed*) George **Papandreou**
Prime Minister

(*Signed*) Nikola **Gruevski**
Prime Minister